Bridging The Retirement Income Gap with FIAs

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What do retirees fear most? According to the 2024 Allianz Life Retirement Study, nearly 2 in 3 Americans (63%) worry about running out of money more than they fear death and 43% attribute high inflation as a contributor to their stress over not having enough money to last for over a lifetime[1].

How can seniors and their financial advocates address this worry? Many are choosing to do so with a fixed index annuity (FIA). LIMRA reports that FIA sales were $95.9 billion in 2023, up 20% from 2022[2]. What's so appealing about FIAs? Before the big reveal, let's set the stage.

Shaky Stool

During the 20th century, a so-called 3-legged stool provided an underpinning for retirees' finances. That is, cash flow could come from 3 sources: Social Security, pensions from former employers, and personal savings.

However, employer pensions have become the exception rather than the rule for many retirees. Pensions are still common for long-term government workers but are relatively rare in the private sector.

Instead of pensions, private sector employers offer employees the opportunity to put wages into defined contribution plans such as 401(k)s. Generally, those dollars go into funds holding stocks and bonds. Recently, though, market volatility has been in the headlines.

Down Year

After a bad year in 2022 (Morningstar reported the broad stock market lost nearly 20% of its value and bonds fell by about 13%), markets have rebounded. According to Morningstar, stocks gained more than 25% in 2023, followed by another double-digit gain in the first half of 2024[3].

Bonds reported a smaller bounce, rising about 5% in 2023 and staying flat in 2024. Why have bonds lagged compared to stocks? One possible explanation is the fear of future inflation, as noted in the Allianz Life Retirement Study mentioned above[4].

Higher inflation often leads to higher interest rates, which drive down bond prices. Although inflation has pulled back from the 40-year highs of 2021 and 2022, the threat of a resurgence hasn't vanished. Another inflationary spike could punish stocks as well as bonds again[5].

To demonstrate the potential effect of such results on an approaching retirement, suppose a hypothetical Holly Smith retires in 2027. By that year's start, Holly accumulated $600,000 in retirement savings, evenly divided between stock funds and bond funds.

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Assume Holly's investments fall by 20% in 2027—25% in stocks and 15% in bonds—because of a pickup in the cost of living. At the start of 2028, her holdings would be down from $600,000 to $480,000. After such a loss, Holly would need a 25% gain to get back to where she had been.

Further, assume Holly had withdrawn 4% of her savings ($24,000) to supplement Social Security in 2027. If so, Holly will bear sequence-of-return risk, which impacts people whose retirement coincides with a bear market.

Holly's choices might be taking that same $24,000 in 2028 from the $476,000 left in her portfolio. That's about a 5% withdrawal rate, which could lead to depletion while Holly is still alive. Or, Holly might stick to her 4% strategy, withdrawing around $19,000 (4% of $476,000) in 2028, which could mean cutting back on her lifestyle in retirement.

Financial markets have bounced back, which could be the case again, helping Holly's portfolio last longer. Even with a rebound, retirees such as Holly face risks such as longevity that could eventually drain her portfolio, inflation that could strain her budget, and a need for costly long-term care. Threats to cut back on Social Security benefits add to Holly's dilemma.

Mitigating Retirement Risks

Savvy planning can help take these key retirement risks off the table, or at least reduce them to the point where retirees are comfortable. Fixed Index Annuities (FIAs) can help mitigate these concerns to the extent that exceeds what other sources of income can provide for retirees.

An FIA is funded either through a single lump-sum payment or a series of periodic contributions from a consumer to an insurance company. In exchange, the consumer receives a contract that may deliver tax-deferred buildup, principal protection in a down market, and growth potential.

Increases to the annuity value, termed interest, are credited to the contract annually, tied to a market index such as the S&P 500. FIA dollars are not directly invested in the index components but are pegged to the results.

Generally, FIAs offer protection against market losses. In return, they usually provide lower upside potential than being invested directly in the market. With a crediting rate of 70% of the S&P 500, for example, a hypothetical 12-month index gain of 10% would generate a 7% crediting rate to the annuity value of an FIA with that provision.

The tax-deferred nature of an FIA allows money to compound over time without having to pay ordinary income taxes on the growth until funds are withdrawn. Consumers have the choice of turning on a reliable income stream from an FIA for a period of time or for a lifetime to supplement other sources of income in retirement.

Bountiful Benefits

On the plus side, considering a fixed index annuity when building a retirement income strategy has several advantages which include:

Tax deferral. Any gains inside an FIA avoids immediate income tax, allowing the annuity owner to take advantage of pre-tax compound growth during the accumulation phase. FIA owners also benefit from flexibility in creating retirement income drawdown strategies by controlling when and how to take income from the annuity.

Asset allocation alternative. Conventional wisdom holds that a 60-40 split, stocks to bonds, combines the growth potential of equities with the stability of fixed income. However, both stocks and bonds suffered double-digit losses in 2022, as previously mentioned. Concerns of ongoing inflation may lead to hesitation regarding investing in bonds.

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An income stream that retirees can't outlive. Americans are living longer than ever. That generally equates to more time spent in retirement and pressure on retirement assets to last longer. Even with Social Security and perhaps other sources of dependable cash flow, there still may be a gap between actual income and desired annual outflow. An FIA can fill that gap, generating income that will last as long as the retiree (and perhaps a spouse) may live.

Principal protection against possible market losses. As explained above, sequence-of-returns risk occurs when financial markets drop early in retirement while a retiree is tapping his or her investment portfolio. That can cause lifelong savings to deplete more rapidly than would have been the case if those market corrections occur later in retirement. An FIA can protect retirement assets by offering a source of cash flow that is not exposed to this risk during a market downturn.

Income to allow deferral of Social Security benefits. Waiting to claim Social Security benefits, perhaps to as late as age 70, can increase lifelong payouts substantially and often increased payments to a surviving spouse. In order to finance such a delay while avoiding additional stress on other assets, an FIA can play a key role. A retiree might start tapping into an FIA at, say, age 62 to bridge income so that Social Security claiming occurs later. Seniors can make their accumulated retirement assets work smarter, not harder.

Support for a surviving spouse. When one spouse dies, the Social Security income benefit of the lower-earning spouse goes away, and the higher benefit is payable to the survivor. Loss of a spouse generally means a decline in income—going from two Social Security benefits to one survivor benefit—so depending on an FIA to replace lost income may be a strategy that can help the survivor maintain the same standard of living.

A hedge against unanticipated long-term care expenses in retirement. Standalone LTC insurance policies can be costly. Data from the American Association for Long-Term Care Insurance put the average premium for a 55-year-old couple on a $165,000 initial policy with a 3% annual growth in maximum coverage at approximately $5,025 per year[6]. That can be an unnecessary expense if the policy benefits are never used.

Nevertheless, LTC coverage may be necessary, because Medicare does not cover custodial LTC and the average cost nationwide for a private room in a nursing home is about $10,025 a month in 2024, according to Seniorliving.org[7]. Adding a long-term care rider to an FIA can provide an additional layer of protection, offsetting the potential expense of a need for LTC.

Spousal benefits. FIAs, when jointly owned, can create income streams over the course of two lives for a married couple. This can be extremely important because widow(er)s typically become single taxpayers, owing increased income tax. What's more, a surviving spouse may not have much experience handling the couple's finances. An FIA offering continued contract ownership to the survivor may provide tax deferral and market risk-free cash flow to an aging widow(er) in need of stable income.

Legacy planning: Non-qualified annuities, with properly named beneficiaries may be utilized as an estate planning opportunity to permit non-spousal beneficiaries, such as the owner's children, to stretch post-death withdrawals over decades, based upon their life expectancy. That's because non-qualified annuities are not covered by SECURE Act's 10-year rule.

Due Diligence

No financial product is perfect for every consumer in every situation, and that's true for FIAs, too. These

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annuities may deliver exceptional results, but there are risks as well. For starters, any guarantees are backed by the issuer, so it's necessary to evaluate the insurer's financial strength; therefore, due diligence is vital. A knowledgeable financial professional can provide real value here.

In addition, FIAs may have costs, just as is the case with any financial product, such as an additional fee for an income rider. Again, a financial professional can help by determining the actual cost of buying a specific FIA to ensure that the product and associated costs meets the specific needs of the investor. The more that is known before buying an FIA, the greater the chance of enjoying the multiple benefits listed above.

Retirement Action Plan:

- Prepare early. Determine a realistic retirement timeline that considers income needs in retirement, sources of retirement income, family history and current investor health.
- Develop a plan that includes guaranteed income sources for predictable and necessary expenses. This plan should aim to fill any projected gaps.
- Recognize the various risks that come with any financial plan, including market risk, healthcare risk, inflation, loss of employment, or death of a loved one. Adjust the approach to minimize such concerns.
- Schedule a plan review at least annually with a knowledgeable financial professional and make needed changes.
- Consider including a fixed index annuity as part of a retirement income plan, to provide needed lifelong income without exposure to possible market weakness.

Sources:

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